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SUBJECT: Taiwan Financial Reform Sinks in Political Mire

SUMMARY AND COMMENT

1. (SBU) It appears unlikely that Taiwan's legislature (LY) will provide supplemental funding for the Financial Reconstruction Fund (FRF) before the scheduled end of the current session on January 21, 2005. The failure to re-fund the program will cripple efforts to consolidate Taiwan's financial institutions and reduce bad debt, the key priorities in Taiwan's effort to improve the health of its financial sector. The failure to reach a compromise between opposition and ruling party FRF funding proposals illustrates a broader problem in Taiwan of how narrow political interests and micromanagement block progress on issues widely recognized as national priorities. END SUMMARY AND COMMENT.

Top Financial Priority Goes Nowhere in LY

2. (SBU) Although the current session of the Legislative LY is scheduled to end on January 21, the ruling DPP and opposition (KMT and PFP) parties appear unable to reach agreement on supplemental funding for the FRF fund designed to help Taiwan's problem banks and other financial institutions deal with mountains of bad debt and exit the market. The supplemental funding bill was listed by both ruling and opposition parties as one of the priority bills to pass during this session, and had been singled out by Premier Yu Shyi-kun, Finance Minister Lin Chuan, and Monetary Affairs Commissioner Gary Tseng as the most important piece of pending financial legislation.

FRF Key to Improving Financial Health

3. (SBU) After the Asian Financial Crisis and global collapse of high-tech stocks, Taiwan began a program of financial reform focused on improving the health of its financial sector by reducing bad debt levels. Since the reform program started in 2001 it has used both incentives and sanctions to reduce bad loans held by Taiwan's financial institutions by over NT\$1.3 trillion (US\$41 billion at NT\$32 per US dollar), over half of the total. The FRF played a key role in this accomplishment by facilitating the purchase of bad debt and allowing problem institutions to be purchased by healthy institutions. The successful sale of the insolvent Chung Shing Bank in December 2004 completely exhausted the FRF's original funding and left it with unfunded outstanding commitments to reimburse some of Chung Shing's creditors. Supplemental funding is also needed to address ten other problem banks and the several problem credit departments of farmers' and fisherman's associations (FAs). Under current legislation designed to spur rapid resolution of problem financial institutions, the FRF faces mandatory dissolution in July 2005.

Willingness to Compromise on Amount

4. (SBU) A year ago Taiwan's Bureau of Monetary Affairs estimated the FRF would require NT\$330 billion in additional funding to assist problem financial institutions eliminate bad debt and exit the market. In 2004 Taiwan's Financial Supervisory Commission (FSC), deferring to the budget deficit, only requested supplemental funding of NT\$222.1 billion (US\$6.9 billion). The bulk of this amount, NT\$193.1 billion, was to assist the ten Taiwan banks with high levels

of bad debt. Another NT\$29.1 billion of the request was to deal with problem FA credit departments. Opposition party LY members proposed cutting the supplemental funding amount by over half to NT\$100 billion (US\$3.1 billion) with the NT\$29 billion to assist problem FA credit departments preserved intact, but with less funding for problem banks. The attention to the FA's reflects their political clout in rural areas.

15. (SBU) Taiwan financial officials told AIT that Taiwan's financial agencies were open to compromise on the amount of supplemental funding for the FRF. Problem banks could be ranked according to the severity of their bad debt burden and supplemental funds used on the most needy cases. FRF would use whatever funding was provided to deal with as many problem financial institutions as possible before it was dissolved in July 2005.

New Element to Supplemental Funding Bill Blocked Compromise

16. (SBU) In mid-December 2004 opposition Legislators proposed an additional element to the FRF supplemental funding bill that would require the Chinatrust Commercial Bank (CCB) to repay the original capital subscriptions of members of the Fengshan credit coop that CCB acquired out of receivership in April 2004. CCB received FRF compensation to make up the gap between liabilities and assets, but the original capital subscriptions were not included in the calculation of compensation. Since financial reforms began in 2001 the number of credit coops has been reduced from 74 to 32. Some credit coop and FA credit department closures have taken place in spite of public protests by FA employees and members. Retroactive repayment of the original capital of the credit coop that CCB acquired would set a precedent for retroactive payments to others of the closed credit coops and FA's.

Political Interests Come to the Fore

17. (SBU) Some opposition party LY members have publicly noted that the 50,000 members of the Fengshan credit coop that CCB acquired could translate into 50,000 votes in the next election. If the compensation were extended to other closed credit coops and FA's it would affect many times that number of people. .

No Funds Left

18. (U) The FRF has assisted 46 problem financial institutions, including 37 FA credit departments, eight credit coops, and two large banks since 2001. Resolution of these problem financial firms reduced the FRF's original funding of NT\$140 billion to NT\$13.7 billion, insufficient to pay the NT\$64.1 billion debt that the FRF promised to Chung Shing's creditor banks in December 2004 (the Ministry of Finance is the guarantor of this commitment).

Comment

19. (SBU) Failure to provide any supplemental funding for the FRF would be a serious setback to Taiwan's financial reforms. Although Taiwan has reduced bad loans by over half since 2001, a number of banks and credit coops are still in poor financial condition. Eleven of Taiwan's 49 banks report NPL ratios above 5% (principal or interest three months or more overdue). Although disappointing in its own right, the LY's failure to act on the FRF serves as a broader reminder that partisan politics continues to impede serious policymaking, even after the major elections in 2004. Leaders in both camps continue to speak optimistically of a new era of cooperation on legislation that is in the public interest, but the track record since December 11 suggests that the next LY, which will look very much like the last one, may be just as ineffective.

PAAL